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**Memorandum**

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to: Appeals Officer  
Financial Product specialist  
Technical Guidance

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subject: Section 1504(a)(4) stock

This advice responds to your request for assistance in responding to a position taken by taxpayers on a case currently in Appeals. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice may not be used or cited as precedent.

**LEGEND**

Corp1 =

Bank =

Sub1 =

State D =

Date 0 =

Date 1 =

Date 2 =

a% =

b% =

c% =

x =

\$y =

Attorneys1 =

## ISSUE

Upon redemption of certain preferred stock, does the payment of unpaid accumulated dividends, compounded daily and reported into income the year in which they accrued, constitute an “unreasonable redemption premium” under § 1504(a)(4)(C)?

## FACTUAL BACKGROUND

### A. The Issuance of the Preferred Stock

On Date 0, Corp1 entered into a series of transactions with Bank. The end result was Corp1 holding \$y in Series A preferred shares (the “Preferred Stock”) of Sub1, a State D corporation controlled and managed by Bank. Corp1 also held Sub1 Series B preferred shares, which held a% of the vote.

The Preferred Stock had a fixed dividend rate of b% per year, compounded daily. The shareholders were entitled to cash dividends on the first two closing dates. Dividends due after the second closing date were accrued and payable at redemption. The Preferred Stock did not have voting rights.

Although the Preferred Stock paid the accumulated dividends only on redemption of the stock, because the fixed dividend rate compounded daily, § 305(b)(4) and § 305(c), working together, required Corp1 to report the dividends as income in the year it accrued. The payment of the accumulated dividends upon redemption was not subject

to the declaration of the Board of Directors, and the shareholders had a legal right to this payment under Sub1's Articles of Incorporation.<sup>1</sup>

B. The "Accreting Dividends" as described in Sub1's Articles of Incorporation

The Preferred Stock's "redemption premium" payment of c% (the "Redemption Premium") of the issue price was calculated by increasing the issue price of the stock by b% per year, compounded daily. Rather than conceptualizing these payments as dividends, as is typical of cumulative preferred stock, Corp1 instead proposes this b% rate of return was only used to calculate the Redemption Premium.

In more detail: following the first two closing dates, at which dividends on the Preferred Stock were payable in cash, Corp1 proposes the "Accreting Period" commenced. During this Accreting Period, the Series A Liquidation Preference (the "Liquidation Preference") on the Preferred Stock increased at the Series A Accreting Dividend Rate (the "Accreting Dividend Rate"), which was b%, compounded daily. The Redemption Premium is defined as the amount per share of the Preferred Stock equal to the Liquidation Preference, which increased at the Accreting Dividend rate over the Accreting Period. This resulted in the c% payment at redemption. Corp1 argues that the c% payment at redemption means the Preferred Stock is not § 1504(a)(4) stock because the c% payment violates § 1504(a)(4)(C).

In other words, the Preferred Stock will be considered § 1504(a)(4) stock only if it satisfies (A), (B), (C), and (D) of § 1504(a)(4). Although Corp1 concedes that the Preferred Stock meets the requirements of § 1504(a)(4) (A), (B), and (D), Corp1 contends that the stock does not satisfy (C), which provides § 1504(a)(4) stock has "redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium)." Corp1 argues that the Preferred Stock fails (C) because the c% payment consisting of the unpaid accumulated dividends upon redemption of the Preferred Stock constitutes an "unreasonable redemption premium."

ANALYSIS

A. Unpaid Dividends Payable at Redemption Necessarily Constitute "Redemption Premiums" for Purposes of § 1504(a)(4)(C)

Corp1 proposes that the b% payments started their life as dividends for purposes of § 243 and § 305(c), and then evolved into an "unreasonable redemption premium" for purposes of § 1504(a)(4)(C) because they were payable only at redemption.<sup>2</sup> In other

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<sup>1</sup> The Field's Memo (May 28, 2010) at 3.

<sup>2</sup> Corp1 has submitted a letter from Attorneys 1 LLP, stating that under State D law, an "accreting dividend" as described in the Sub1 prospectus, does not exist under State D law and therefore the Accreting Dividends are paid in the form of a redemption payment. This letter, however, acknowledges

words, Corp1 wants the payments characterized as dividends when it needs the DRD, but then also claims the same payments constitute a redemption premium when it needs to disqualify the Preferred Stock from § 1504(a)(4).

In more detail: Corp1 claims that because the payment is termed as a “redemption payment,” the tax analysis must begin in § 302. In order to term the payment as a dividend, Corp1 argues that the payment must be “essentially equivalent to a dividend” under § 302(b)(1). This is not correct. Per § 302(d), one would first need to determine whether the redemption of the Preferred Stock could fit in any of the four categories in § 302(b) when determining whether the redemption is to be treated as a sale or exchange. For example, if both classes of Preferred Stock were redeemed, Corp1 could treat the redemption as a “complete termination of interest” under § 302(b)(3) and thus qualify for sale or exchange treatment. Yet, if Corp1 qualified for sale or exchange treatment on the Redemption Premium, Corp1 would not qualify for a DRD on the Preferred Stock because there would be no dividends received.

In short, Corp1 needs the b% payments to be termed dividends in order to qualify for the dividends received deduction. Corp1’s post-hoc argument that the “Accreting Dividends” constitute a redemption payment and thus the tax analysis must begin in § 302 ultimately weakens Corp1’s position that it is entitled to a dividends received deduction under § 243(c) for the years in which it reported the dividends.

B. Because the Board Did not Declare a Dividend, Any Payment At Redemption Must Constitute a Redemption Premium

Corp1 also argues that because there was no vested right in the shareholders to receive the accumulated dividends until redemption, the payment of the accumulated dividends on redemption must qualify as a redemption premium. Corp1 contends that the payments could not possibly be dividends if they were only payable at redemption.

Corp1 relies on the fact that a shareholder has no legal right to a dividend until declared. See Rev. Rul. 69-130; Rev. Rul. 69-131. Corp1 then argues because the shareholders had no legal right to the dividends until redemption according to the terms of the stock, the c% payment cannot be categorized as a dividend, and therefore must be a “redemption premium.” This argument neglects the crucial fact that Corp1 already included the dividends into income in the years in which they accrued because they were constructively received dividends under § 301 by reason of § 305(b)(4) and § 305(c).

If CC:CORP were to accept Corp1’s reasoning, any cumulative preferred stock would not yield dividends; instead, it would invariably produce an “unreasonable redemption

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this analysis is limited to State D law, and does not address the federal income tax consequences of this payment’s characterization, which is what we are concerned with here.

premium” when the unpaid dividends were paid at redemption.<sup>3</sup> CC:CORP has already considered this issue and informally determined that unpaid dividends on cumulative preferred stock, together with the stock’s issue price, do not constitute an “unreasonable redemption premium.” In PLR 200329028 (April 11, 2003), we stated: “The Series X Preferred stock redemption rights and the liquidation rights that can be exercised by Corp 2 each equate to the issue price of the stock (gg # per share) together with dividend arrearages,” and such stock “will not be stock within the meaning of § 1504(a)(4)” because redeeming stock at its issue price, plus any unpaid dividends, does not constitute an “unreasonable redemption premium.”

C. The Definition of “Redemption Premium” in § 305(c) is Controlling for Purposes of § 1504(a)(4)(C)

Corp1 also contends that the definition of “redemption premium” in § 305(c) is controlling for the purposes of § 1504(a)(4)(C). CC:CORP disagrees.

First, the purpose of the regulations under § 305 is to prevent corporations from using redemption premiums to pay preferred shareholders the equivalent of dividends that are instead taxed at capital gain rates. In contrast, § 1504(a)(4) attempts to distinguish between preferred stock that is limited in nature (“plain vanilla”), to preferred stock that actually shares in the future appreciation, increase in earnings, or growth of the corporation. Although the word “redemption premium” occurs in both § 305(c) and § 1504(a)(4)(C), the code sections are not interrelated and there is no indication in the scant legislative history of § 1504(a)(4)(C) that an unreasonable redemption premium for purposes of § 305(c) was meant to serve as a benchmark for § 1504(a)(4)(C).

At one point in time the Service did accept for ruling purposes that a redemption premium considered reasonable under the safe harbor rules in § 1.305-5(b)(2) would be considered a reasonable redemption premium for purposes of § 1504(a)(4)(C). See PLR 8753005 (Dec. 31, 1987). However, because the safe harbor rules under § 1.305-5(b)(2) no longer exist, the safe harbor standard no longer applies for purposes of § 1504(a)(4)(C).<sup>4</sup>

Today, it remains unclear what constitutes an “unreasonable redemption premium” for purposes of applying § 1504(a)(4)(C). In fact, commentators have advised taxpayers to request a private letter ruling in advance of any transactions relying on the operation of

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<sup>3</sup> See Response to the Corp1 and Affiliates Response to the Notice of Proposed Adjustment, Dated Date 1 (Date 2) at 4 (“Nonvoting stock that bears a fixed rate yield should not fail the requirements of section 1504(a)(4)(C) merely because the yield is not paid currently and results in dividend accruals under section 305.”).

<sup>4</sup> See Dubroff, Federal Income Taxation of Corporations Filing Consolidated Returns, 1-11 Taxation of Corps Filing Consolidated Returns § 11.03 (2011).

§ 1504(a)(4)(C) in order to obtain more definitive guidance on the status of what constitutes a unreasonable redemption premium.<sup>5</sup>

D. Does § 305(c) create a separate class of deemed shares for purposes of applying § 1504(a)(4)(C)?

An alternate argument exists that because § 305(b)(4) and § 305(c) required Corp1 to report the dividends into income as they were accrued, these “deemed” shares need to be separated from the “actual” shares when calculating the redemption price.

Accordingly, the redemption price was the issue price of the “actual” shares, meaning there was no “unreasonable redemption premium” for purposes of § 1504(a)(4)(C).

CC:CORP’s view is that § 305(c) and § 305(b)(4) do not create a separate set of “deemed” shares for purposes of applying other code sections, such as § 1504(a)(4)(C). Rather, § 305(c) and § 305(b)(4) merely require a shareholder to report dividends into income as they are accrued, which are then added to the shareholder’s basis in the stock. Using § 305(c) rules to create a separate class of “deemed” shares that must be reported separately at redemption is outside what Congress intended when drafting § 305(c).

Although this argument reaches the correct result—the redemption price of the Preferred Stock did not include the b% payments which were properly reported as dividends under § 305(b)(4) and § 305(c)—CC:CORP feels that the best way to arrive at this result does not include the § 305 rules because it complicates the issues. Additionally, overreliance on § 305(c) could prove problematic because of the different policies underlying § 305(c) and § 1504(a)(4)(C).

CONCLUSION

Corp1 is attempting to classify the Accreting Dividends on the Preferred Stock as the rate at which the Redemption Premium on the Preferred Stock increased over an x-year period.<sup>6</sup> CC:CORP is of the opinion that accepting this line of reasoning would yield to the following flawed conclusion: Corp1 can manipulate the rules of § 1504(a)(4)(C) by recasting constructively received dividends under § 305(b)(4) and § 305(c) as the rate at which a preferred stock’s redemption premium increases over the period prior to redemption.<sup>7</sup>

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<sup>5</sup> See id.

<sup>6</sup> Corp1 has submitted a letter from Attorneys 1 LLP, stating that under State D law, an “accreting dividend” as described in the Sub1 prospectus, does not exist under State D law and therefore the Accreting Dividends are paid in the form of a redemption payment. This letter, however, acknowledges this analysis is limited to State D law, and does not address the federal income tax consequences of this payment’s characterization, which is what we are concerned with here.

<sup>7</sup> See Response to Corp 1. and Affiliates Response to the Notice of Proposed Adjustment, dated Date 1 (Date 2) at 4 (“Nonvoting stock that bears a fixed rate yield should not fail the requirements of section

CC:CORP continues to agree with Exam's original argument: that the Accreted Dividends on the Preferred Stock were properly reported as dividends under § 305(c) and § 305(b)(4). The dividends were then added to Corp1's basis in the Preferred Stock. Accordingly, our view is that because the Accreted Dividends were already reported during the relevant tax years, they are not part of the Redemption Premium for purposes of § 1504(a)(4)(C). After subtracting the already reported dividends from the price paid at redemption, it becomes clear that the Preferred Stock was redeemed at its issue price. Accordingly, the Preferred Stock satisfies (C) of § 1504(a)(4): stock which has "redemption and liquidation rights which do not exceed the issue price of the stock."

Corp1 has already conceded that (A), (B), and (D) are satisfied. The fact that CC:CORP has determined the Preferred Stock also satisfies (C) means that the Preferred Stock is § 1504(a)(4) stock. Accordingly, Corp1 is not entitled to a § 243(c) deduction for any dividends paid on the Preferred Stock because stock described in § 1504(a)(4) does not count for purposes for applying § 243(c).<sup>8</sup>

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1504(a)(4)(C) merely because the yield is not paid currently and results in dividend accruals under section 305.") (emphasis added).

<sup>8</sup> Corp1 is likely eligible for an 70% DRD under § 243(a)(1), meaning that the AMT will apply. Additionally, Corp1's 70% DRD will likely be reduced by the limitations on debt-financed portfolio stock in § 246A(c).